

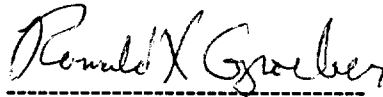
Accountant Liability to Third Parties for Negligence

An Honors Thesis (HONRS 499)

by

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A handwritten signature in cursive script, reading "Ronald X. Groeber", is positioned above a horizontal dashed line.

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Purpose of Thesis

The thesis is limited to the discussion of accountant liability to third parties for claims of general negligence. The paper analyzes the past legal trends in determining accountant liability. Along with the discussion of past trends, the paper discusses the present trend in limiting accountant liability to third parties.

The American Institute of Certified Public Accountant's (AICPA) *Principles of Professional Conduct* recognizes its accountants' professional obligation is to the general public. The principles state that accounting work has an increasing importance in modern society as more third parties rely upon the accounting statements to make financial decisions.<sup>1</sup> However, the law does not recognize a negligent accountant's professional duty to the American public. The recognition can only be obtained by utilizing the foreseeable approach in third party liability cases involving accountant negligence.

Like most areas of early American law, the law pertaining to accountant liability to injured third parties was derived from the English common law. Before the organized stock market and the government's demand for audited financial statements, accountants were viewed by the public as management consultants.<sup>2</sup> The professional duty was owed to the client's management, and the opinion was reflected in the adopted nineteenth century English common law standard.

An example of the English common law theory can be found in the 1833 case of *Price v. Easton*.<sup>3</sup> The English court held that Price, although economically injured by Easton, did not have the standing to bring a lawsuit against Easton because Price was not a named party in the disputed contract. Price's entitlement to the money derived from a contract between Easton and another party. Price was said to be a "third party" in the situation, and, at the time, the English

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<sup>1</sup>. PRINCIPLES OF PROFESSIONAL CONDUCT, ET §§ 51-53 (Am. Inst. of Certified Pub. Accountants 1988).

<sup>2</sup>. Rebecca Szczepanski, *Stockler v. Rose: Michigan's Role in the "Play" of Third Party Liability for Negligent Accountants*, 42 WAYNE L. REV. 195 (1995).

<sup>3</sup>. *Price v. Easton*, 4 Barn. & Alol. 433 (1833).

courts were only available to remedy-seeking parties that were named in the original contract.<sup>4</sup>

The named parties in a contractual agreement are said to be in "privity of contract."<sup>5</sup>

The limitation of privity in cases involving accountants was based upon the assumption that the accountant was a watchdog for their client's management and duty of care was only owed to the client. Although accountant liability to injured third parties was nonexistent under the English and early American systems of law, the American legal system attempted to evolve to acknowledge the expanding role of accountants in modern society.<sup>6</sup> In 1879 the United States Supreme court laid the groundwork to allow for liability claims by a specific group of injured third parties.

In *Savings Bank v. Ward*<sup>7</sup> the Supreme Court created two exceptions to the privity restriction in American law. The Court's decision stated that injured third parties could bring a lawsuit against the wrongdoer when the injuries were caused by fraud or acts which were "imminently dangerous" to the lives of others.<sup>8</sup> The Court's ruling did not grant a third party the standing to sue when the its economic injuries were the result of a negligent accountant; however, the decision did allow a third party who was injured by an act of fraud to bring a lawsuit against the fraudulent accountant.

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<sup>4</sup>. *Winterbottom v. Wright*, 152 Eng. Rep. 402 (Ex. 1942).

<sup>5</sup>. *Black's Law Dictionary*, West Pub., 1199 (6th ed. 1990).

<sup>6</sup>. Dennis Orlinski, *An Accountant's Liability to Third Parties: Bily v. Arthur Young Co*, 43 DEPAUL L. REV. 858 (1994).

<sup>7</sup>. 100 U.S. 195 (1879).

<sup>8</sup>. *Id.* at 205-206.

Fraud, a "knowing" or a "reckless" disregard for the truth,<sup>9</sup> is a relatively small problem in the accounting profession.<sup>10</sup> The AICPA *Code of Professional Conduct* prohibits fraud, and allows for the dismissal of fraudulent accountants.

Negligence, a "thoughtless slip or blunder,"<sup>11</sup> is defined in *Black's Law Dictionary* as "the failure to use such care as a reasonably prudent and careful person would use under similar circumstances."<sup>12</sup> Accountant negligence, a larger problem for accountants than fraud, is an area of law that had slowly begun to react to the expanding role of the accountant in modern society.

Professional negligence by accountants occurs when the accountant fails to perform the accounting service in accordance with generally accepted accounting principles (GAAP) or generally accepted auditing standards (GAAS).<sup>13</sup> Until 1959, GAAP was the unwritten set of standards that were commonly practiced by fellow accountants. Discrepancies arose between different accounting firms and geographical locations, and a clear understanding of what was GAAP, a needed element in a successful negligence suit, was difficult to establish.

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<sup>9</sup>. *Black's Law Dictionary*, 661. See *supra* note 5.

<sup>10</sup>. Marc Epstein and Albert Spalding, *The Accountant's Guide to Legal Liability and Ethics*, Irwin Publications, 57 (1992).

<sup>11</sup>. See, *Ultramares v. Touche*, 174 N.E. 441, 445 (N.Y. 1931).

<sup>12</sup>. *Black's Law Dictionary*, 1032. See *supra* note 5.

<sup>13</sup>. Bonita Daly and John Gibson, *The Delineation of Accountants' Legal Liability to Third Parties: Bily and Beyond*, 68 ST. JOHN'S L. REV. 609, 621 (1994).

In 1959 the American Institute of Certified Public Accountants' (AICPA) Accounting Principles Board (APB), under pressure from the Securities and Exchange Commission, defined and codified GAAP as the set of standards which had passed its authoritative board as correct accounting procedure.<sup>14</sup> The standards were widely published in pronouncements by the APB and distributed to the AICPA members. The clarified GAAP and the large following of the AICPA further unified the standards of accounting services.

Besides establishing that the accountant did not follow correct accounting procedures, the plaintiff of a successful negligence claim must also demonstrate the presence of the following elements:

1. The accountant owed a duty of care to the plaintiff;
2. The plaintiff suffered a loss;
3. The accountant's breach of the duty of care caused the plaintiff's loss.<sup>15</sup>

The claim of negligence is a state tort, and the states have complete autonomy in determining security and accountant liability laws that will be adhered to within their political jurisdictions.<sup>16</sup> In the cases heard in federal courts, the federal courts will determine which state's security and accountant liability laws will be employed based upon the residency of the dominant plaintiff.<sup>17</sup>

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<sup>14</sup>. Dan Goldwasser and Thomas Arnold, *Accountants' Liability*, Practicing Law Inst., 1-5 (1996).

<sup>15</sup>. *Id.*, 4-4.

<sup>16</sup>. *Id.*, 1-29.

<sup>17</sup>. *Id.*, 1-30.

Because of states' autonomy, all states do not have to adhere to the same approach in determining to whom their accountants owe a professional duty of care. In determining whether a third party can bring a liability suit against a negligent accountant, the states follow one of three general approaches: 1) the near privity standard; 2) the *Restatement* standard; and 3) the foreseeable standard.<sup>18</sup> In cases involving fraud, a recent analysis of state laws found that all states' laws, but one, allow injured third parties to bring liability claims against fraudulent accountants.

The first approach takes the most restricted view in determining an accountant's liability for negligent actions that cause injury to third parties. As mentioned before, the privity rule for claims of negligence was acquired from English common law. The privity standard was exhibited in the 1931 *Ultramares v. Touche*<sup>19</sup> decision of the New York Court of Appeals. The ruling was written in an era before governmental regulations required published, audited financial statements, and it demonstrated the public's belief that an accountant's duty of care was owed to management.

Ultramares Corporation (Ultramares) brought suit against the accounting firm of Touche, Niven & Company (Touche). The lawsuit stemmed from Touche's audited financial statements of Fred Stern and Company (Stern). The audited statements reported Stern's net worth at over \$1 million.<sup>20</sup>

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<sup>18</sup>. Orlinski, 860. See *supra* note 6.

<sup>19</sup>. 174 N.E. 441 (N.Y. 1931).

<sup>20</sup>. *Id.* at 442.

Stern, actually insolvent, had created over \$700,000 worth of fictitious accounts receivables to obtain a \$165,000 loan from Ultramares. When Stern defaulted on the loan, Ultramares brought a negligence claim against Touche arising from Touche's failure to uncover the fabricated accounts during the audit.

In addressing the claim of negligence, Justice Benjamin Cardozo concluded that Ultramares, an injured third party whose injury was unquestionably caused by Touche's negligence, did not have a standing to bring a lawsuit against Touche. In the ruling Justice Cardozo wrote:

If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class.<sup>21</sup>

Nine years earlier, in *Glanzer v. Shepard*,<sup>22</sup> Justice Cardozo had ruled in favor of an injured third party who brought a claim of negligence against a public weigher. In the *Ultramares* decision Cardozo examined the difference in the relationships between the third parties, and why one third party could successfully bring a negligence claim and the other third party could not.

In *Glanzer*, Shepard was a public bean weigher employed by the seller to weigh beans for the buyer, Glanzer. Shepard weighed 905 bags of beans and handed a certification attesting to

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<sup>21</sup>. *Id.* at 444.

<sup>22</sup>. 135 N.E. 275 (N.Y. 1922).



the weight directly to Glanzer. Upon attempting to sell the beans, Glanzer became aware that the certified weight was overstated and brought a negligence suit against Shepard.

In *Glanzer* Justice Cardozo wrote that New York law imposed a duty of care upon the weigher towards the buyer because:

The plaintiff's use of the certificates was not an indirect or collateral consequence of the action of the weighers. It was a consequence which, to the weighers' knowledge, was the end and aim of the transaction.<sup>23</sup>

Cardozo referred to the relationship between the weigher and the third party as "so close as to approach that of privity, if not completely one with it."<sup>24</sup>

In denying the claim of negligence against Touche, Justice Cardozo called Ultramares one of the members of the "indeterminate classes" who presently, or in the future, might rely upon Touche's audited statements. Judge Cardozo did not believe the conceptual criteria needed to establish close privity, as in *Glanzer*, was obtained by Ultramares.

Justice Cardozo, Chief Justice of the New York Court of Appeals, was one of the leading jurists of his time. His court was considered a leader in judicial opinions and the second most respected court in the country.<sup>25</sup> Over the years many courts and legislative bodies embraced the privity rule, and judges used their own discretion to determine if an injured third party conformed to the *Glanzer* exception.

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<sup>23</sup>. *Id.* at 275-276.

<sup>24</sup>. *Id.* at 275.

<sup>25</sup>. Denzil Causey and Sandra Causey, *Duties and Liabilities of Public Accountants*, Accountant's Press, 174 (1994).

Justice Cardozo did not assign explicit criteria to determine if the relationship of a third party to an accountant lacked privity, as in *Ultramares*, or was "akin to privity" as in *Glanzer*. In 1985 the New York Court of Appeals developed a three-prong test to determine if a plaintiff had a relationship "sufficiently approaching privity"<sup>26</sup> and a standing to bring claim against the negligent accountant.

The three-prong test was established in *Credit Alliance v. Arthur Andersen & Company*.<sup>27</sup> The New York Court of Appeals ruled that when parties lacked strict privity of contract, the following prerequisites must be met to successfully bring suit against an accountant for negligence:

1) the accountant must be aware that the financial reports were to be used for a particular purpose or purposes; 2) in the furtherance of which a known party or parties was intended to rely; and 3) there must have been some conduct on the part of the accountants linking them to that party or parties, which evinces the accountants' understanding of that party or parties' reliance.<sup>28</sup>

*Credit Alliance* is a slightly more expansive approach than that of privity, but it is still reminiscent of the English common law and the belief that an accountant owes the duty of care to the contracting party.

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<sup>26</sup>. 483 N.E.2d at 119. See *supra* note 27.

<sup>27</sup>. 483 N.E.2d 110 (1985).

<sup>28</sup>. *Id.* at 118.

In *Ultramares* Justice Cardozo feared the "indeterminate class," and the *Credit Alliance* decision is not a departure from *Ultramares*; it merely establishes a set of criterion for judges to determine which third parties will qualify as being akin to privity. Most parties lacking actual privity of contract will not be included under *Credit Alliance*'s privity standard since it would require the plaintiff to prove words, or actions, of the accountant and something in the engagement that confirmed a "nexus approaching privity."<sup>34</sup>

The privity standard was developed before governmental regulations mandated audited financial statements of publicly traded companies. The standard does not recognize the expanded role of an accountant to the investing public when issuing audited financial statements. In *Ultramares* Judge Cardozo wrote, "public accountants are public only in the sense that their services are offered to any one who chooses to employ them."<sup>35</sup> While the role of accountants has increased since the *Ultramares* decision, the standard has not evolved to recognize the increased duty of care owed by accountants to third parties.

In 1968, a federal district court, applying the laws of Rhode Island and New York, became the first court to favor the use of the Section 552 of the *Restatement (Second) of Torts* to determine accountant liability to injured third parties for negligence. In the case, the court cited the inherent unfairness of the privity standard to third parties.<sup>36</sup>

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<sup>34</sup>. *Credit Alliance* at 120. See *supra* note 27.

<sup>35</sup>. *Ultramares*, at 448. See *supra* note 19.

<sup>36</sup>. 284 F. Supp. 85 (D.R.I. 1968) at 37.

In the case of *Rusch Factors v. Levin*<sup>37</sup>, the contested situation was similar to the circumstances in the *Ultramares* case. In *Rusch*, a third party creditor relied upon negligently prepared financial statements. The reliance resulted in the issuance of a loan. When the audited company defaulted on the loan, the creditor brought a negligence suit against the accountant.

The federal court adopted the tentative draft of Section 552 of the *Restatement (Second) of Torts*. The drafters of the *Restatement* had created a two-prong test to determine liability of a negligent accountant:

- 1) Liability extends to any persons, or members of a limited class of persons, that the accountant intends or knows will use the financial information,<sup>38</sup>
- 2) And the injured party must be in a class of persons who used the financial statements for "substantially the same purpose" as the bona fide client.<sup>39</sup>

Under the *Restatement* approach, the accountant owes a duty of care to the person or limited group of people whose reliance is actually foreseen by the accountant, even if the specific identity of each person is unknown.<sup>40</sup> This two-prong test can be achieved by the accountant presenting the financial statement to the third party directly, or by the accountant knowing that the client will forward a copy of the financial statements, for agreed upon reasons, to the third party.

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<sup>37</sup>. 284 F. Supp. 85 (D.R.I. 1968).

<sup>38</sup>. Goldwasser and Arnold, 1-16. See *supra* note 14.

<sup>39</sup>. *Id.* 1-17.

<sup>40</sup>. Hanson and Rockness, 43. See *supra* note 32.

The *Restatement* approach, unlike that of the privity standard, does not require a specific name of the third party, but does require precise disclosure to the accountant of the intended use of the financial statements.<sup>41</sup> The disclosure must be made before the accounting work is completed, and the accountant must acknowledge the use of the statements by the third parties.

As an example, under the *Restatement* approach, an accountant who negligently prepared financial statements for a client under the knowledge that the financial statements were to be used to obtain a bank loan, could be held liable to the unidentified bank that provided the client a loan, if the loan was based upon information contained in the negligently prepared financial statements. If the accountant prepared financial statements with the understanding that the statements were to be used by a second corporation to determine whether to allow the client to purchase goods on credit, but instead, the second corporation relied upon the statements to purchase an interest in the audited corporation, the accountant could not be held liable under the *Restatement* approach for losses incurred if the statements were negligently prepared.<sup>42</sup> The *Restatement* approach requires specific, prior disclosure of the use of the financial statements by third parties and acknowledgment from the accountant.

In *Rusch* the court wrote:

With respect, then to the plaintiff's negligence theory, this court holds that an accountant should be liable in negligence for careless financial misrepresentation relied upon by actually foreseen and limited classes of persons. According to the plaintiff's complaint in the instant case, the defendant knew that his certification

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<sup>41</sup>. Epstein and Spalding, 45. See *supra* note 10.

<sup>42</sup>. Hanson and Rockness, 43. See *supra* note 32.

Thirdly, the injured third parties must have relied upon the negligently prepared financial reports.<sup>47</sup> Courts have taken a rigid interpretation of this requirement. Republished information, such as by Dunn and Bradstreet, and secondhand information, such as by a financial advisor, does not entitle the plaintiff to hold the negligent accountant liable for injuries. The plaintiff must be able to demonstrate that it relied upon the actual statements that were negligently prepared.

Fourthly, the accountant owes no duty of care to a third party that relied upon information contained in a confidential report to the client.<sup>48</sup> Many accountants, in an attempt to curve their third party liability, issue reports with disclaimers on the face of the documents. The disclaimers state for whom the report was prepared and the conditions of the confidentiality agreement. The argument is that if the report was to be confidential, the accountant could not have foreseen the third parties' reliance, and owes no duty of care to the third parties under Section 552 of the *Restatement (Second) of Torts*.

In *Rusch* the court cited a number of justifications for adopting the *Restatement* approach. The reasons include: spreading the risk of loss, avoiding the results of a third party bearing an inequitable amount of loss due to negligence, and the *Restatement's* presumed deterrent effect on negligently prepared audits of the financial statements.<sup>49</sup> The *Restatement* approach is the most

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<sup>47</sup>. *Raritan River Steel v. Cherry, Beckaert & Holland*, 367 S.E.2d 609 (N.C. 1988).

<sup>48</sup>. *Pahre v. Auditor of State*, 422 N.W.2d 178 (Iowa 1988).

<sup>49</sup>. Goldwasser and Arnold, 1-18. See *supra* note 14.

widely followed of the approaches in determining negligence claims brought by injured third parties against accountants.

A recent analysis of court precedents show that twenty-three states follow the *Restatement* standard. While the standard recognizes an accountant owes a duty of care to other parties besides those in privity, the standard does not recognize the full ramification of audited financial statements in today's world. Except for one case in Alabama, the courts have not interpreted the *Restatement* approach to cover the many third parties who purchase stock in the audited company based upon the soundness of the balance sheet.

The final approach that states use for determining the liability of negligent accountants to injured third parties is called the foreseeable standard. The approach is the most extensive approach that is currently in use.<sup>50</sup> In general, under the foreseeable standard, the negligent accountant can be held liable to all injured third parties whose reliance upon the financial statements were "reasonably foreseeable" by the accountant.<sup>51</sup>

The foreseeable standard does not limit recovery to the primary beneficiaries (*Credit Alliance* approach), or to the limited class of foreseen users (*Restatement* standard), but it recognizes the accountants' duty of care owed to other foreseeable third parties.<sup>52</sup> As mentioned earlier, the presence of an accountants' duty of care to an injured third party is a requirement for a successful negligence claim.

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<sup>50</sup>. Epstein and Spalding, 52. See *supra* note 10.

<sup>51</sup>. 461 A.2d 138 (N.J. 1986). See *supra* note 55.

<sup>52</sup>. Epstein and Spalding, 52. See *supra* note 10.

Judge Howard Wiener was an influential proponent of the foreseeable standard. He was a member of the appellate court and served on the panel in a 1980 case involving Touche Ross. Touche Ross settled out of court before Judge Wiener and his colleagues rendered their decision.<sup>53</sup> Three years after the settlement Judge Wiener published an article in the *San Diego Law Review*. The law article outlined the need for the acceptance of the foreseeable standard in determining a negligent accountant's liability to third parties.

Justice Wiener wrote:

Accountant liability based on foreseeable injury would serve the dual function of compensation for injury and deterrence of negligent conduct. Moreover it is just and rational judicial policy that the same criteria govern the imposition of negligence liability, regardless of the context in which it arises. The accountant, the investor, and the general public will in the long run benefit when the liability of the certified public accountant for negligent misrepresentation is measured by the foreseeability standard.<sup>54</sup>

The first court to accept the foreseeable standard was the New Jersey Supreme Court in *Rosenblum, Inc. v. Adler*.<sup>55</sup> Rosenblum had accepted Giant Corporation's stock as payment in a business transaction. Rosenblum relied upon the audited statements prepared by Touche Ross to value Giant's stock. In the audit of Giant, auditors failed to detect large amounts of falsely recorded assets and material amounts of deleted liabilities. When Giant filed for bankruptcy,

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<sup>53</sup>. Goldwasser and Arnold, 4-26. See *supra* note 14.

<sup>54</sup>. Howard Wiener, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 SAN DIEGO L. REV. 233 (1983).

<sup>55</sup>. 461 A.2d 138 (N.J. 1983).



Rosenblum's stock became worthless. Unable to recover the value of the stock from the insolvent Giant, Rosenblum brought a claim of negligence against Touche Ross.

The New Jersey Supreme Court found no reason to hold the auditors to a different standard of care than that imposed upon other suppliers of products or services to the public.<sup>56</sup> The court endorsed the idea of granting recovery to the foreseeable, injured third parties stemming from negligent actions. In rendering its decision, the Court noted the changing roles of accountants' in modern society:

Auditor's function has expanded from that of a watchdog for management to an independent evaluator of the adequacy and fairness of financial statements issued by management to stockholders, creditors, and others.<sup>57</sup>

In 1986 the California Court of Appeals also noted the changing role of accountants' work, from internal uses, such as by management, to external uses, such as by stockholders. The court emphasized the role of the independent accountant to third parties in *International Mortgage Company v. John P. Butler Accountancy Corporation*<sup>58</sup> when it rendered its decision to allow a real estate developer to recovery damages from the accountant for negligently prepared financial statements.

Other courts that have endorsed the foreseeable standard have cited a number of different justifications. The Mississippi Supreme Court rationalized that the legal trend was moving away

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<sup>56</sup>. *Id.* at 142-146.

<sup>57</sup>. *Id.* at 152.

<sup>58</sup>. 218 (Cal. Ct. App. 1986).

from the privity standard.<sup>59</sup> The New Jersey and Wisconsin High Courts noted the accountants' ability to obtain malpractice insurance under the foreseeable approach.<sup>60</sup> The courts also noted that accountants can spread the costs of insurance to the general public by raising their prices of services.<sup>61</sup> The foreseeability standard was viewed by the courts, and Justice Wiener, as a strong deterrent to negligent actions by accountants.<sup>62</sup>

While the foreseeable standard for accountant liability is very broad, the courts have established some restrictions. One court cited the reason of public policy to limit the liability when the injury was out of proportion to the culpability of the negligent accountant.<sup>63</sup> Two courts have held that under the foreseeable approach, the negligent accountant can only be held liable to injured third parties that received the financial reports directly from the audited company.<sup>64</sup>

In 1987 Mississippi was the last state supreme court to adopt the foreseeable approach. The foreseeable approach imposes a duty of care upon accountants towards the public, who

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<sup>59</sup>. *Touche Ross & Co. v. Commercial Union Ins. Co.*, 514 So. 331, 321 (Miss. 1987).

<sup>60</sup>. *Rosenblum*, 461 A.2d 138 (1983); *Citizens State Bank v. Timm, Schmidt & Co.*, 335 N.W.2d 361 (Wis. 1983).

<sup>61</sup>. *Rosenblum*, 461 A.2d 138 (1983); *Citizens*, 335 N.W.2d 361 (Wis.1983).

<sup>62</sup>. Goldwasser and Arnold, 4-27. See *supra* note 14.

<sup>63</sup>. *Citizens*, 335 N.W.2d 361, 366 (Wis. 1983).

<sup>64</sup>. *Touche Ross & Co. v. Commercial Union Ins. Co.*, 514 So.2d 315, 322 (Miss. 1987); *Rosenblum*, 416 A.2d 138, 153 (1983).

invest in audited companies after relying upon the financial statements. This assumption that the financial statements will be utilized by the public is consistent with the AICPA's *Principles of Professional Conduct*. However, in 1992, led by a lobbying effort by the AICPA,<sup>65</sup> a disturbing trend to reduce a negligent accountant's liability to third parties gained momentum.

In *Bily v. Arthur Young & Company*<sup>66</sup> the California Supreme Court was asked by the plaintiff to apply the foreseeable standard, as was adopted in *International Mortgage Company v. John P. Butler Accountancy Corporation*. Arthur Young audited Osbourne Computer Corporation's 1981 and 1982 financial statements in preparation of going "public." The initial public offering (IPO) would allow for much needed capital. Bily, a third party creditor, extended credit to Osbourne as a "bridge loan" until the IPO. Bily had relied upon the 1982 audit report of Arthur Young in determining to extend credit and was paid by common stock in private placements. Robert Bily, a director of the financing company, purchased \$1.5 million in private placement stock. Competition from IBM and a large amount of unrecorded liabilities caused cash flows to falter in mid 1983. The planned IPO was not achieved, and the company filed for bankruptcy in September of 1983.

During the trial, an expert witness testified that there were more than 40 violations of GAAS in Osbourne's audited statements, including a \$3 million understatement of liabilities.<sup>67</sup> The trial court returned a verdict against Arthur Young for accounting negligence. The

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<sup>65</sup>. Andrea Andrews and Gilbert Simonetti, Jr., *Tort Reform Revolution*, J. ACCOUNTANCY, 54, September 1996.

<sup>66</sup>. 834 P.2d 745 (Cal. 1992).

<sup>67</sup>. *Id.* at 748.

California Court of Appeals, citing the foreseeable approach, affirmed the decision. The auditors appealed to the California Supreme Court.

California Supreme Court Chief Justice Malcolm Lucas wrote the majority opinion. In analyzing the three different approaches in determining liability to third parties, the California Supreme Court concluded that the *Restatement* approach was the best.<sup>68</sup> The court's opinion effectively overturned the implementation of the foreseeable standard in *International Mortgage Company v. John P. Butler Accountancy Corporation*.

Justice Lucas' opinion declined to give all foreseeable third parties the right to sue negligent accountants. The majority justified the *Restatement* as the best approach because of three issues that were present in *Bily v. Arthur Young*. The court felt that under the foreseeable standard an auditor faced liability out of proportion to the degree of fault.<sup>69</sup> The court acknowledged the sophisticated class of plaintiffs who could have utilized contractual laws or their own auditors to control risk.<sup>70</sup> It also cited the lack of empirical data to support the idea that the foreseeable standard acted as the intended deterrent of negligent accounting actions.<sup>71</sup>

The *Bily v. Arthur Young* decision returned California to the *Restatement* approach in determining the accountant liability to third parties for negligence. The decree reversed and remanded the earlier courts' rulings in *Bily v. Arthur Young*.

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<sup>68</sup>. *Id.* at 769.

<sup>69</sup>. *Id.* at 761-764.

<sup>70</sup>. *Id.* at 764.

<sup>71</sup>. *Id.*

Judge Lucas' dismissal of the foreseeable standard was premature. The foreseeable approach was less than ten years old, and if it had been given a chance to establish itself, Judge Lucas and his colleagues at the California Supreme Court would have realized that it was the "fair and just" standard to follow in cases of accountant negligence.

Judge Lucas cited the fear of uncontrollable losses that could have been incurred under the foreseeable standard, but accountants had been required to obtain malpractice insurance under the Securities and Exchange Acts, and they had no trouble obtaining additional insurance as a result of the more expanded liability rules.<sup>72</sup> The purchase of insurance allows the losses to be spread out among the accounting industry and the public, who utilize the financial statements.

Judge Lucas commented on the "sophistication" of the third parties in *Bily*, and the parties' ability to obtain their own independent audit. Third parties, whether sophisticated or not, should be able to rely upon the audit statements by public accountants regardless of the parties' talents. In 1984 the United States Supreme Court ruled in *United States v. Arthur Young & Company*<sup>73</sup> that:

By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client.<sup>74</sup>

The Supreme Court recognized the unique role of the accountants in business and investment

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<sup>72</sup>. Orlinski, 904-905. See *supra* note 6.

<sup>73</sup>. 465 U.S. 805 (1984).

<sup>74</sup>. *Id.* at 817.

transactions, and imposed a duty of care upon the accountants under the title of "public responsibility."

The California Supreme Court also noted in *Bily* that there was a lack of empirical data demonstrating that the foreseeable approach was a deterrent to negligent accounting practices. Not only was the foreseeable standard too young to be fully implemented, it had only been implemented in four states. Such emerging trends would require longer than a couple years to establish the empirical data.

On the other hand, statistical data is not reassuring that the current methods of determining negligent accounting liability to injured third parties, mainly privity and *Restatement* standards, are an effective deterrent to negligent accounting practices. In 1991 the six largest accounting firms ("Big 6") paid almost \$2 billion in fines, and over \$30 billion in legal claims were pending against accountants.<sup>75</sup> If the approach to determining an accountant's duty of care in cases of negligence was to be solely based upon the standards functional use as a deterrent, it would appear that the privity and *Restatement* approaches are not appropriate standards.

In the early 1990's the AICPA initiated a lobbying effort to further reduce the liability of accountants.<sup>76</sup> The AICPA, with its national membership of over 300,000<sup>77</sup> accountants and their respective state accounting societies, lobbied for legislative and judicial action to reduce the legal

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<sup>75</sup>. Michael Cook, *Liability Crisis in the United States: Impact on the Accounting Profession*, J. ACCOUNTANCY., 19, Nov. 1992.

<sup>76</sup>. Andrews and Simonetti, 54. See *supra* note 65.

<sup>77</sup>. Goldwasser and Arnold, 1-4. See *supra* note 14.

liability of negligent accountants to third parties. In 1992, the *Bily* decision marked a beginning to the restricting of accountant liability; the disturbing trend continues today.

States may pass laws specifically limiting the liability of negligent accountants to injured third parties.<sup>78</sup> In general, the legislative statutes limit an accountant's liability to varying degrees of the privity standard. The changes in security laws are not retroactive, but the statutes are considered to be a part of the state's presiding security laws, and they directly affect future judicial interpretations, which might require a departure from an established precedent.

Statutes in the states of Arkansas,<sup>79</sup> Illinois,<sup>80</sup> and Utah<sup>81</sup> are similar. The acts prevent accountants from these states from being held liable for an "indeterminate amount for an indeterminate time to an indeterminate class."<sup>82</sup> The judicial interpretations of the statutes are relatively narrow in scope, and the laws represent codification of the privity standard.

The state of Mississippi<sup>83</sup> adopted a legal statute specifying that a negligent accountant can be held liable to injured third parties. The statute, the only one of its kind in the nation, codified the foreseeable approach in determining accountant liability for economic losses to third parties. The Mississippi Supreme Court cites the statute in dicta when ruling on cases involving accountant liability for negligent practices.

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<sup>78</sup>. *Id.*, 4-30.

<sup>79</sup>. ARK. STAT. ANN. § 16-114-302.

<sup>80</sup>. ILL. COMP. STAT. ANN. chap 225, § 450/30.1.

<sup>81</sup>. UTAH CODE ANN. § 33-3-201.

<sup>82</sup>. *Ultramares*, at 444. See *supra* note 19.

<sup>83</sup>. MISS. STAT. § 11-7-20.

In 1995, the state of New Jersey, home of the *Rosenblum* case, implemented *An Act Concerning Accountants' Liability*.<sup>84</sup> The act was the result of lobbying efforts by the AICPA and the New Jersey accountant society. The New Jersey laws reflect a codification of the *Credit Alliance* ruling, in that it requires that the plaintiff of the negligence suit prove there was a "link," either by words or conduct, with the accountant that demonstrated the accountant's understanding of the claimant's intended reliance on the financial statements.

In 1995, besides New Jersey, Wyoming also legislated a state securities law dealing with accountant liability to third parties.<sup>85</sup> Wyoming's law has yet to be tested in a court, but is the most restrictive in its view of accountant liability to third parties. The statute limits accountant liability to parties that are specifically named in a statement of purpose, which is attached by the accountant to the finished financial statements. The statute's limitations also apply for claims of fraud. Wyoming is the first, and so far only, state to limit parties eligible to bring suit against accountant's for both fraudulent and negligent practices.

In 1996, the AICPA called for intense lobbying efforts by its members in the states of Alabama, Arizona, Massachusetts, Michigan, and Texas to assist legislation of the privity statute in each state's securities laws.<sup>86</sup> During the lobbying efforts in Massachusetts, the AICPA stated that an increasing amount of their accountants' time and effort was being dedicated to defending

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<sup>84</sup>. N.J. STAT. 2A:53A-25.

<sup>85</sup>. WYO. STAT. § 33-3-201.

<sup>86</sup>. Andrews and Simonetti, 56. See *supra* note 65.



themselves in lawsuits.<sup>87</sup> The AICPA believes that by limiting the number of parties eligible to bring lawsuits against negligence accountants, the accountants will have time to complete more audits and other accounting related procedures.

The AICPA urges the states to accept the privity standard as the best approach to use in determining the liability of negligent accountants to injured third parties, but the foreseeable standard is the approach that is most agreeable to the AICPA's *Principles of Professional Conduct* and commensurate with the accountant's role in today's business transactions. Only the foreseeable approach acknowledges the accountants' duty of care owed to the general public when issuing external financial reports. In fact, the imposition of the foreseeable approach is the best way to meet the AICPA's desire for less litigation; the approach encourages accountants to perform competent audits the first time and, as a result, lessen the number of injured third parties.

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<sup>87</sup>. Maria Shao, *Bill Limiting Accountants' Liability Goes to House*, BOSTON GLOBE, July 17, 1996, C5.

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